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Economic outlook / Belaruski Ėkanamičny Dasledča-Adukacyjny Centr

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BEROC Economic  
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# Economic Outlook

Third Quarter 2021

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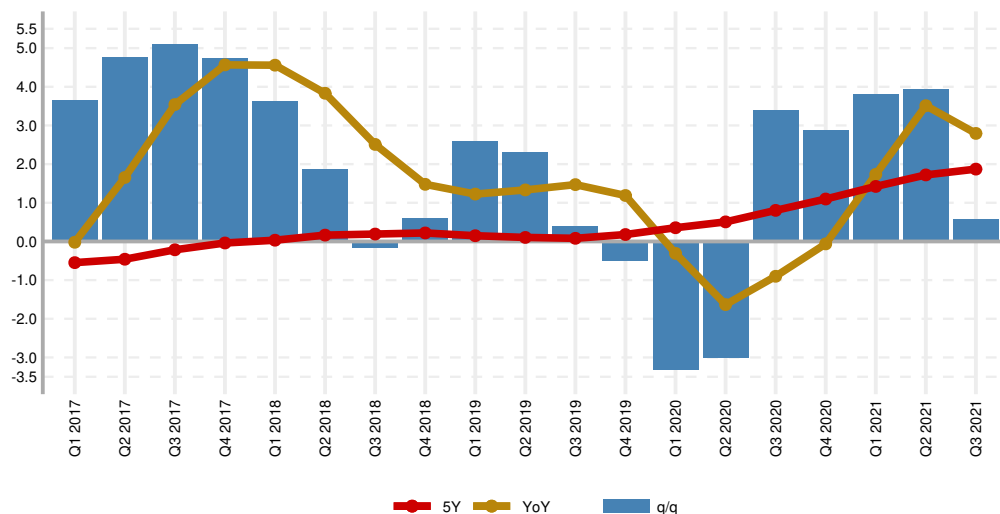
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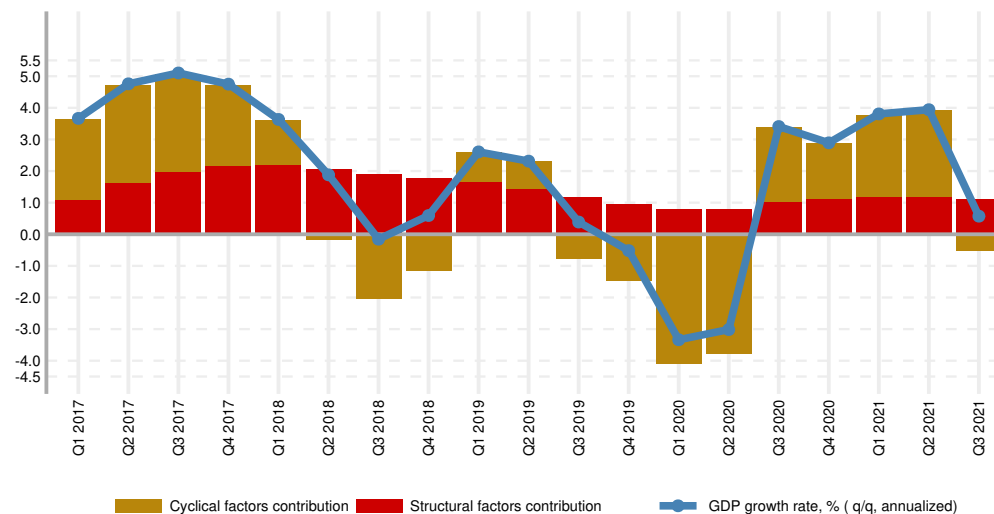
## Foreign trade miracle inertia and growth fading

- Output growth with no drivers and drive
- Inflation has slowed down. For how long?
- Strengthening of firms' financial position; fiscal, external position and financial stability indicators
- A jump in price competitiveness
- Export contraction
- Inflation pushes income inequality

GDP growth rate, %  
(seasonally adjusted, annualized)



Decomposition of GDP growth: the contribution of structural and cyclical factors, percentage points



1. By default Belstat reports GDP growth rates (i) on accrual basis and (ii) vs. the same period of a previous year. The series of such growth rates turn out to be flat, but it 'hides' new signals in output dynamics. In internationally accepted practice series of the annualized growth rates between two consecutive quarters (with a seasonal adjustment) are more frequently employed. Such growth rates reflect the tendencies of the output with respect to a particular quarter (including the last one). The series of annual average growth rates (not on accrual basis) allow to avoid high volatility of previously mentioned indicator and embeds the information about the last quarter to the previous year context. Finally, average annualized growth for last 5 years (not on accrual basis) could be viewed as indicator characterizing the environment of the long-run growth. **The data for the past quarter are estimate.**

2. Decomposition of GDP to structural and cyclical component is made by means of univariate Kalman and Hodrick-Prescott filters. Final decomposition is a result of averaging of these two approaches. In terms of growth rates, such decomposition demonstrates contribution of structural and cyclical factors to growth rates of the output. However, it doesn't focus on the current state of the trend (potential) output and output gap (corresponding estimates of levels may differ significantly (than estimates of growth rates) in comparison to estimates based on another decomposition techniques).

## Current trends

### Economy of contrasts: business cycle goes down, financial performance improves

Output growth stalled sharply in Q3. A sharp deceleration of growth after a relatively successful Q2, the prevailing negative news background gives grounds to expect that the downturn phase of the business cycle may quickly give way to a cyclical slowdown.

In the current environment, the latter is associated with a recession. The behaviour of many real variables points precisely to the preparation of the economy for the coming recession. Consumer and investment demand, the main components of domestic demand, have started to contract again after a slight spike in the first half of the year. Overall, domestic demand has been on a downward spiral for the last 18 months. Individual spikes fade quickly, falling in line with a declining trend.

The deterioration in Q3 probably also occurred (based on preliminary data) in net exports. The volume of exports fell noticeably more than imports. In other words, both key components of the foreign trade miracle, that is, strong export growth and lagging import growth, began to falter.

For the time being, however, there are still doubts about the exhaustion of the foreign trade miracle. Firstly, further adjustments in the data are likely to correct the overall picture. So far, GDP growth in Q3, albeit meager, contrasts with the simultaneous contraction of the main elements of domestic demand and net exports (this is possible with a tangible growth of other elements of domestic demand, which is doubtful). Secondly, the global environment, due to a new sequence of disruptions in production and logistics chains, combined with active demand stimulation, maintains a state that can still generate “special effects”.

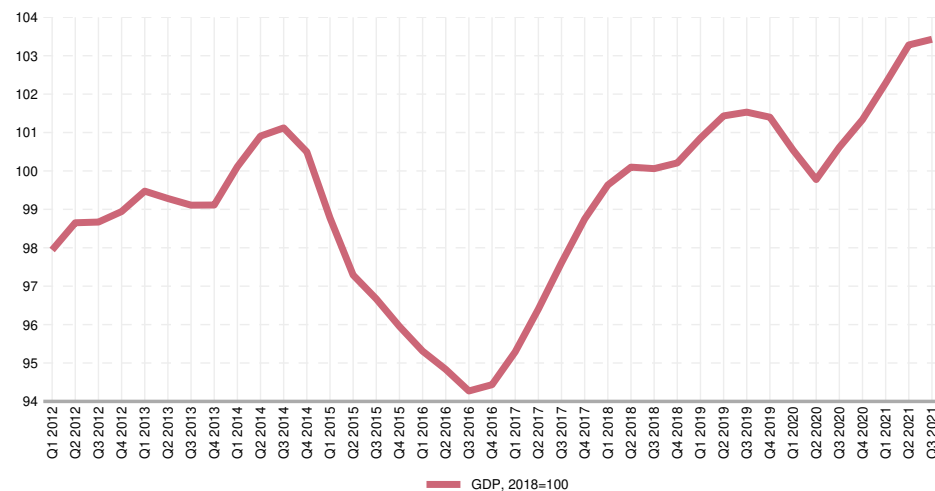
In Q3, such was the new price spikes in the global economy. For Belarus, this led to a surge in terms of trade and increased price competitiveness. Combined with inertia from the foreign trade miracle of previous periods, this led to an improvement in the financial position of firms at the micro level and indicators of financial stability at the macro level.

As a result, the situation in Q3 was unusual: the contraction in economic activity was combined with an improvement in firms' financial positions, fiscal position and indicators of financial stability and positive trends in the financial markets. The latter also contributed to a damping of inflation, although it remained in the elevated range.

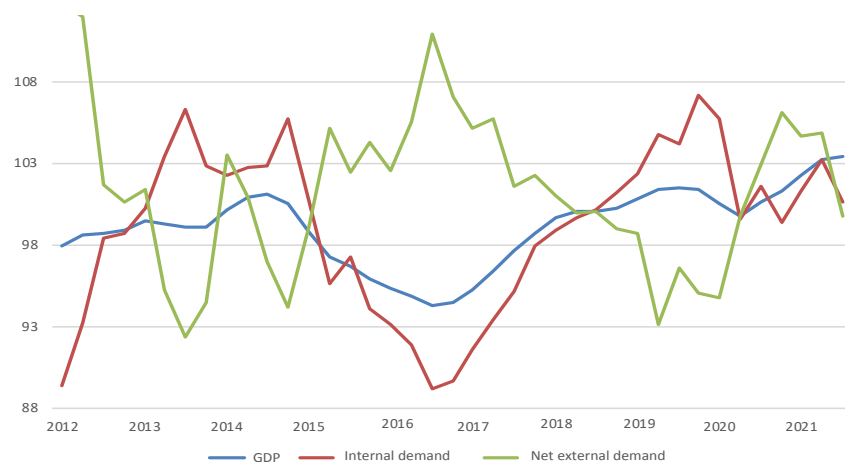
But fundamentally, the economic environment remains very vulnerable and unstable. The hope of maintaining the foreign trade miracle is counterbalanced by depressed domestic demand, sanctions, and possible disruptions and shocks in the global economy. In these circumstances, the “fork” of scenarios 2022 for Belarus is very wide: from growth of about 2% (as in 2021, if the foreign trade miracle continues and exports grow) with increased inflation, to a deep recession combined with financial destabilization. A limited recession scenario (up to 3%) with inflation in the vicinity of 10% seems somewhat more likely than the others for 2022.

## Development trends

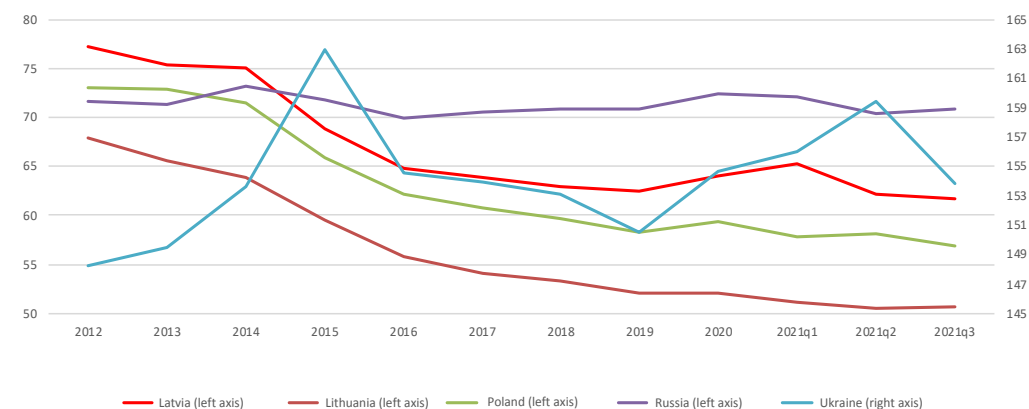
Level of output, 2018=100



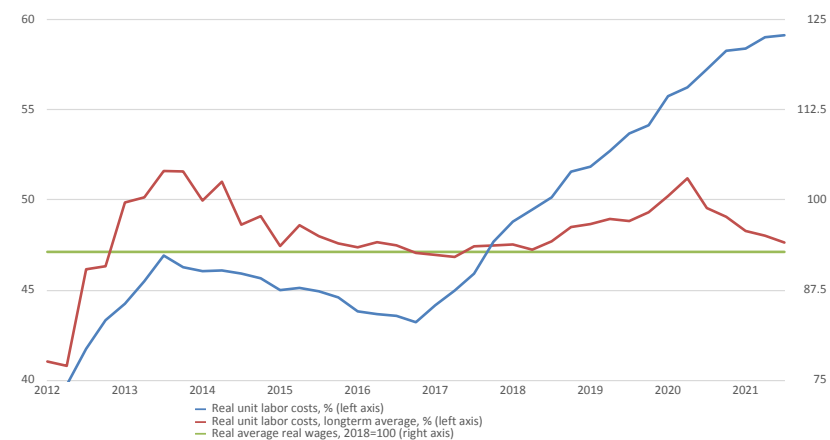
GDP, internal and net external demand\*\*, 2018=100



Relative well-being\* in Belarus vs. neighbours, %



Real wages and real unit labor costs.



\* - Well-being here refers to GDP per capita at PPP in international dollars of 2017. Data from 2020 are estimates based on real GDP per capita growth rates in these. The indicator presented in the chart is the ratio of well-being in Belarus compared to one in the relevant neighboring countries, in percentages.

\*\* - The indicator of net external demand is calculated as the difference between the export and import indices according to the SNA, in which 2018 is the base, that is, 2018 = 100. 100 is added to the resulting value for comparability with other indices in which 2018 is the base.

# Institutional environment

## Diving into a swamp of uncertainty

Belarus has been in a stagnation-debt trap for at least 5 years. Weak growth (due to numerous structural flaws) makes it impossible to “grow out of debt” in an evolutionary way. In turn, a high debt burden blocks growth.

Firstly, directly, by “putting credit shackles” on firms and the state budget. Secondly, indirectly, by narrowing the permissible floating band of the national currency. A significant depreciation of the exchange rate in an environment dominated by foreign currency debt threatens to become a trigger for a debt crisis. Hence, output growth has become strongly dependent on the natural dynamics of external demand and the state of net exports, because it is risky to restore the external position via the exchange rate.

The institutional changes taking place over the past 18 months are exacerbating the situation. The vicious stagnation-debt cycle is likely to gradually turn into a recession-debt funnel. The main reason for this is seen to be the further deterioration of growth prospects. Before the coronavirus, the central estimate was around 2.5% p.a. In the current environment – against the background of a deep domestic political crisis and depressed economic sentiment, the Russian oil manoeuvre, sanctions and escalation of relations with Western countries – equilibrium growth has preconditions to decrease. The foreign trade miracle has so far veiled this trend, making it difficult to identify it with quantitative methods. But it is highly likely that under the new conditions equilibrium growth is in the range of 0-1.5% p.a.

With growth at such a low equilibrium level, adapting to new conditions, let alone negative shocks (exhaustion of positive ones), threatens to quickly lead to a recession. In this case, the problem of debt (un)sustainability is rapidly re-emerging. The margin of safety accumulated during the foreign trade miracle is not large at both the micro and macro level. Debt shocks are likely to lead to a new round of economic contraction.

Belarus will come to such a situation in 2022, if the foreign trade miracle is exhausted and/or the impact of sanctions causes a significant export shock. Further events will be determined by the behaviour of the authorities. One of the options for their behaviour is to accept the recession as a necessary evil and to smooth it out, hoping that the slide into a recession-debt funnel will be slow and that it will be possible to wait for better times. This approach is partly akin to the first covid episode in March-July 2020. Another option would be to try to prevent the recession by all means, despite the macroeconomic constraints at hand. Such an approach is similar to the 2011 response and is fraught with price and financial destabilisation.

Apart from each of the scenarios described being bad, they are also qualitatively heterogeneous. From today's perspective, this exacerbates widespread uncertainty, making the prospects for development under the political status quo increasingly dim and bleak.

## Background information

### Escalation and fading of the migration crisis

The main event of Q3 was the migration crisis, bringing Belarus back to the top of the global media agenda. The EU member states were mostly able to overcome their internal contradictions and react to it in a coordinated manner. The main reaction to Belarus was the tightening of sanctions.

### New sanctions packages on Belarus

New sanctions packages were adopted in a coordinated manner by the EU, the US and the UK. They are based on targeted sanctions against Belarusian individuals and legal entities (mainly large companies). From a macro perspective, this sanctions package looks more like an addition, closing loopholes, to the previous sectoral package. Restrictions on Belarusian state debt may also play a significant role in this package. But overall, the mechanism for the implementation of the sanctions and the extent of their impact on the national economy still has a considerable degree of uncertainty.

### Counter-sanctions, political crisis escalation and pressure on foreign businesses

The response of the Belarusian authorities in the economic sphere has been the so-called counter-sanctions against the Western countries – the imposition of restrictions on food imports. Another trend was a new wave of political repression. Open pressure was exerted by the authorities on the mobile operator A1.

### A new integration package with Russia has been signed; the gas price is stable, and Belarus wants a new EDB loan

Escalation within the country and with the Western states has been accompanied by a trend towards increasing dependence on Russia. In September, A.Lukashenko signed a package of 28 so-called alliance programmes with Russia. Their full texts are not publicly available. They probably form the basis for Russia's progressive promotion of its interests in Belarus. Another novelty of the authorities in the relations with Russia (and mirrored with Ukraine) was their verbal readiness to recognize Russia's ownership of Crimea. Following this "warming", the Belarusian authorities managed to get Russia to keep the gas price in 2022 identical to 2021 and also voiced its willingness to get a new loan of USD 3.5 bn through the EDB mechanism.

### A new attempt to approach the debt problem

After years of hardship, the authorities have approved a mechanism for trying to resolve the problem of bad debts (Decree 391). It boils down to the idea that bad debts can be made good by restructuring them and organising new management standards in debtor enterprises. By doing so, it is planned to avoid the recognition of large-scale losses, and where they are unavoidable, they will have to be absorbed by the budget. The success of such a strategy, as well as the ability of the budget to assume the ultimate risk of bad debts, is highly questionable.

## Output and demand

### Growth without drivers and drive

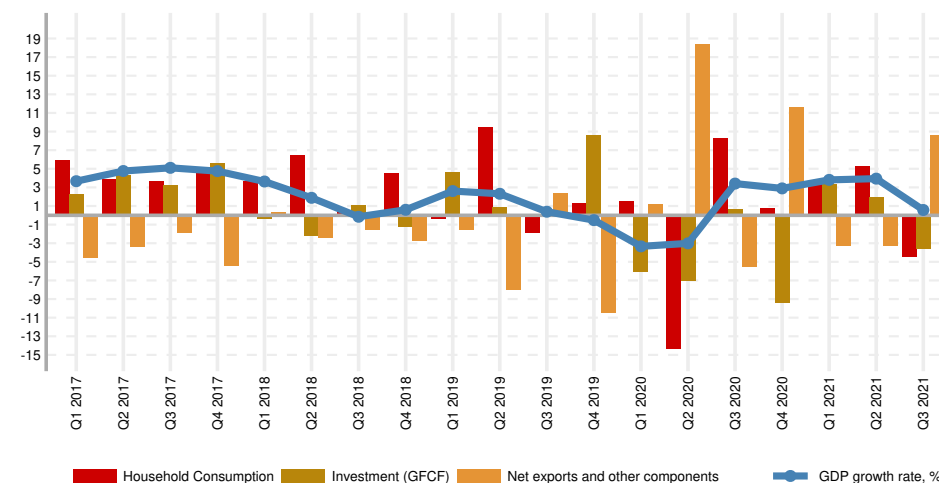
The sharp slowdown in Q3 to near zero indicates that the main drivers of previous periods are fading, with a shortage of new ones to replace them.

On the demand side, net exports (external demand) have all but exhausted their role as growth donors. At the same time, the main components of domestic demand – household consumption and investment – declined synchronously. The persistence of sluggish positive growth, probably (estimates for Q3 are based on preliminary and incomplete data for demand components), is mainly connected with “secondary” elements of aggregate demand (investment in inventories, expenditures of public institutions). Overall, this picture vividly visualises a weakened growth potential and a lack of natural mechanisms for demand expansion.

On the production side, the growth of its main industry donor of the last year, the processing industry, has dried up. Its output fell massively for the first time since the Corona crisis at once by 5.6% (by Q2 in annual terms, with seasonality eliminated). In most large industries, output also contracted ((construction, agriculture, transport), or growth was sluggish (trade). Only the information and communication sector remained a significant contributor to growth.

Despite the fading growth, productivity growth has weakened only slightly, due to a decline in employment.

Contribution to output growth, percentage points



Note: The rate of the GDP growth and the relevant contribution of demand components are annualized quarter on quarter (with a seasonal adjustment); GFCF is gross fixed capital formation.

Quality growth indicators



Note: The proxy for the return on capital is calculated as a ratio of the annual average output growth to the share of GFCF in GDP.



## Monetary sector

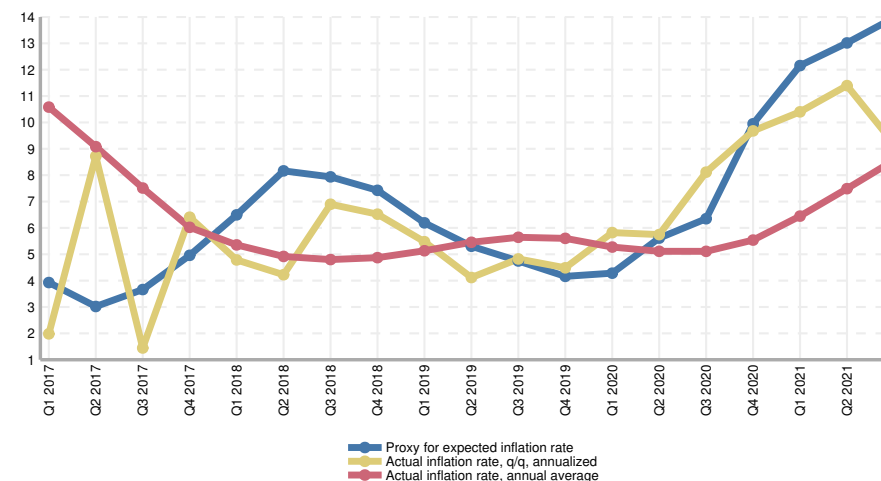
### Inflation has finally slowed down. For how long?

After a long period of acceleration, inflation has slowed down. The main reason for this is seen as an increase in credit and deposit market interest rates, due to a relaxation of the National Bank's restrictive measures (abandoning the restrictions on foreign currency deposit rates and adjusting the Estimated Standardised Risk Rate values). Consequently, credit activity was limited, and monetary aggregates continued to shrink in real terms, despite a small nominal increase. A slight ruble appreciation, both in nominal and real terms, also played a stabilising role for inflation. Finally, regulated prices also had a dampening effect on CPI in Q3: during the quarter, core inflation caught up with consolidated inflation, from which it had lagged throughout the first half of the year.

However, the Q3 disinflationary trend is unlikely to be sustainable. Firstly, the economy has not yet fully adapted to the external reflationary effects of past periods. A large proportion of firms are targeting higher prices in the coming periods to stabilise their financial position. Secondly, the ground for inflation is laced with high inflationary expectations of consumers. Thirdly, the National Bank is still trying to waltz with different priorities without showing any willingness to confront inflation decisively.

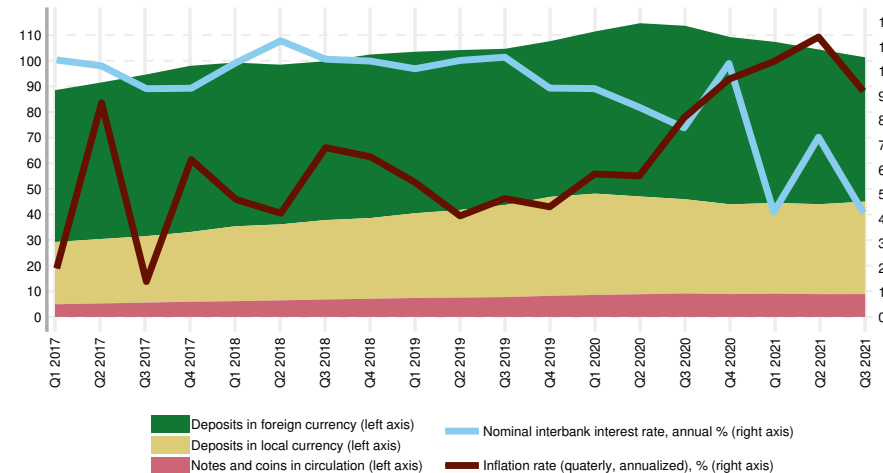
Fourthly, even if ready, the ability of the National Bank (due to loss of administrative weight and lack of instruments) to suppress inflation effectively is questionable.

### Inflation and inflation expectations %



Note: The inflation expectations are calculated on the basis of the methodology developed by Kruk (2016). All the indicators are annualized in percent. The quarterly inflation is seasonally adjusted.

### Interbank interest rate and monetary aggregates



Note: M3 components correspond to the scale M3 2015=100. All the indicators are seasonally adjusted in real terms.

## Financial stability

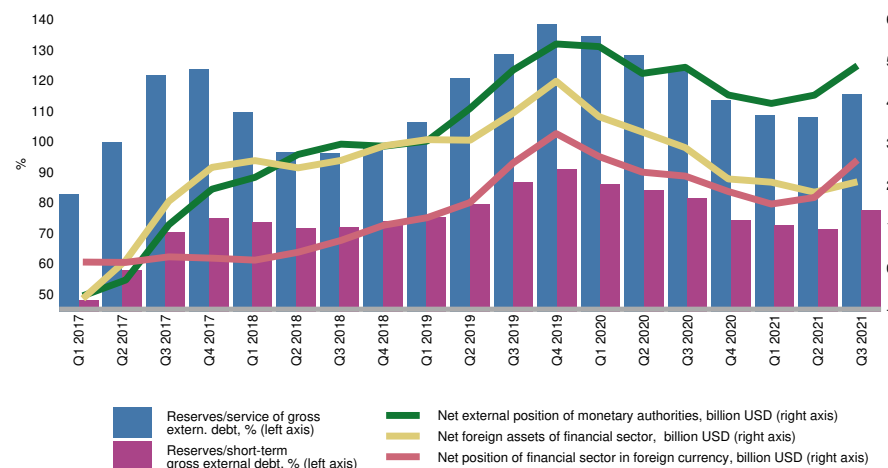
### Trend change in liquidity in foreign currency

In Q3, the almost two-year trend of deteriorating liquidity indicators in the foreign currency was reversed. This was facilitated by a net supply of foreign currency in the domestic market (around USD 0.7 bn), which allowed for the replenishment of the FX reserves. Slightly more than half of this oversupply was generated by households. At the same time, they continued to reduce balances on foreign currency deposits, while slightly increasing balances on rouble deposits. This trend has also contributed to the improvement of foreign exchange liquidity. The common reason for all these trends seems to be the inertia of the foreign trade miracle. In the beginning (Q1 and Q2), the foreign exchange market stabilised due to the miracle, and subsequently, due to lower fears of households, there was a surplus of foreign exchange on the foreign exchange market. As the foreign trade miracle wears off, the situation is likely to reverse once again.

### The burden of private debts is decreasing

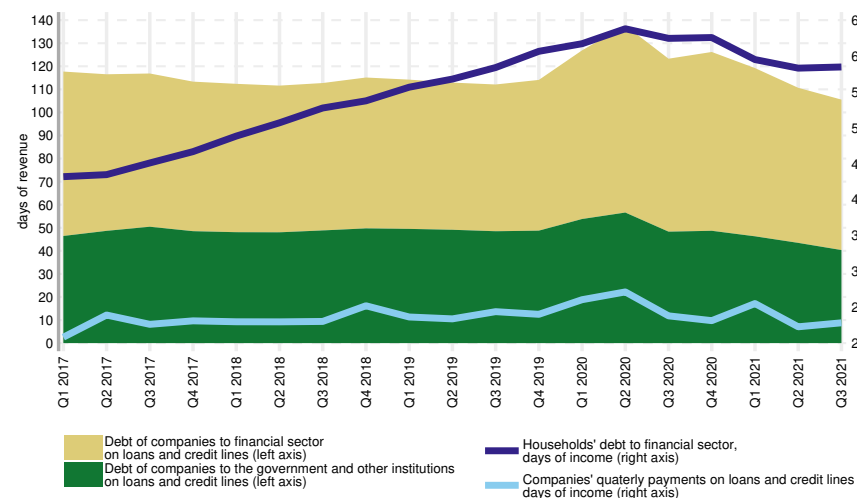
The foreign trade miracle had a stabilising effect on the credit market and debt state. In the first half of the year, firms repaid their credit obligations on a net basis, reducing their overdependence on borrowing. By Q3, they were able to significantly increase their own working capital, and even began to build up deposits with banks. These trends were also combined with banks' preferences. Ultimately, this led to a strengthening of the downward trend in debt burden.

### Foreign exchange liquidity indicators



Note: The indicators of reserve assets are as of the beginning of the quarter. The gross external debt service includes interest and principal payments for the previous 12 months. The net external position of the monetary authorities is calculated as the difference between the reserve assets and the costs associated with them over the coming 12 months.

### Size and quality of private debt



Note: Companies' liabilities to the government etc. under loans are calculated as the difference between the total amount of companies' liabilities under loans and their liabilities under loans provided by the financial sector.

## Fiscal sector

### Fiscal position has strengthened

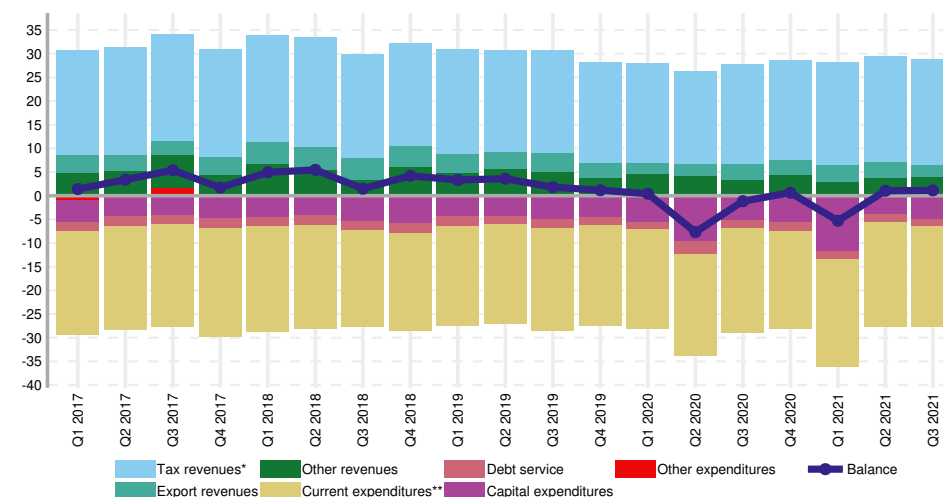
In Q3, the consolidated budget was executed with a surplus of 1.1% of GDP (for the 9 months as a whole, at the expense of Q1, it is still deficit). The revenues decreased by 0.7% of GDP in comparison to Q2. Also, the current level of revenues (around 28.5% of GDP) remains significantly lower than the comfort level of the previous years (2017-2019) (by about 2.5% of GDP). At the same time, the revenue situation is noticeably better than originally planned for the current year. Therefore, the following characteristics are appropriate for the revenue side at the same time: tangibly worse than in the “fat days”; slightly worse than in Q2 at the peak of the foreign trade miracle; still better than the scenario on the basis of which the budget was drawn up. Expenditures again adapted to the dynamics of revenues, shrinking by 0.8% of GDP.

The main contributors to the positive revenue trends were the profit tax and the VAT, bearing the echoes of the foreign trade miracle. Negative trends, both short-term and long-term, were primarily related to FEA revenues and excise taxes. Expenditures have shrunk mainly at the expense of salaries and accruals, although the share of these items remains at an elevated level in the medium-term context.

### The burden of public debt has shrunk to some extent

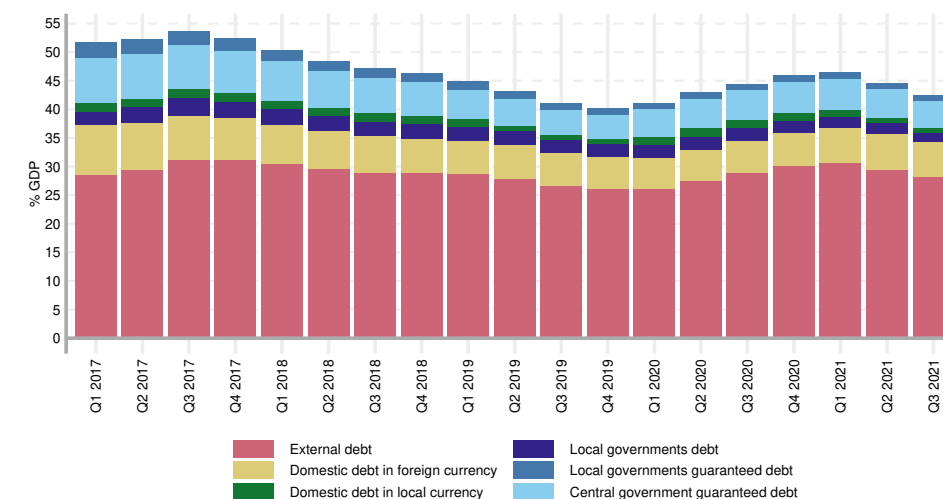
The burden of public debt has continued to decrease. This was due to both a decrease in public debt (due to net repayment with a deficit in borrowing sources) and an increase in GDP.

### Consolidated budget performance, % GDP



Note: \* - without taxes on foreign trade; \*\* - without public debt service. % GDP values are seasonally adjusted quarterly flows.

### Public debt, %GDP



Note: Quarter average.

## External sector

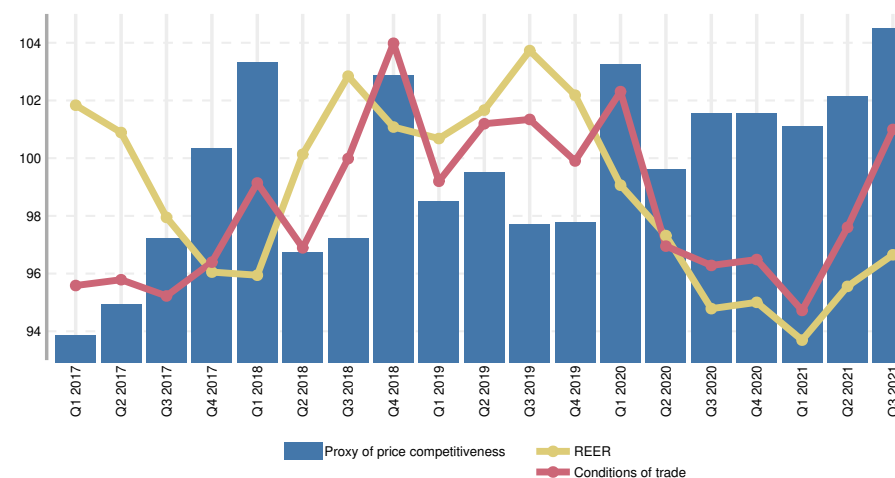
### A jump in price competitiveness is a key to the trends of the 3rd quarter

In Q3, the main manifestation of the foreign trade miracle was the favourable price dynamics on foreign markets. Export prices grew noticeably faster than import prices, which led to a significant improvement in the terms of trade. This led to an accelerated growth of foreign exchange earnings and contributed to the strengthening of the national currency. However, the National Bank kept nominal appreciation in check. This created an additional headroom in price competitiveness, and it allowed the National Bank to buy out the excess supply of foreign currency, replenishing gold reserves. This gave rise to key favourable trends in Q3: strengthening of firms' financial positions, fiscal and external positions, and improved liquidity in foreign currency.

### Global growth is taking hit, inflation remains high

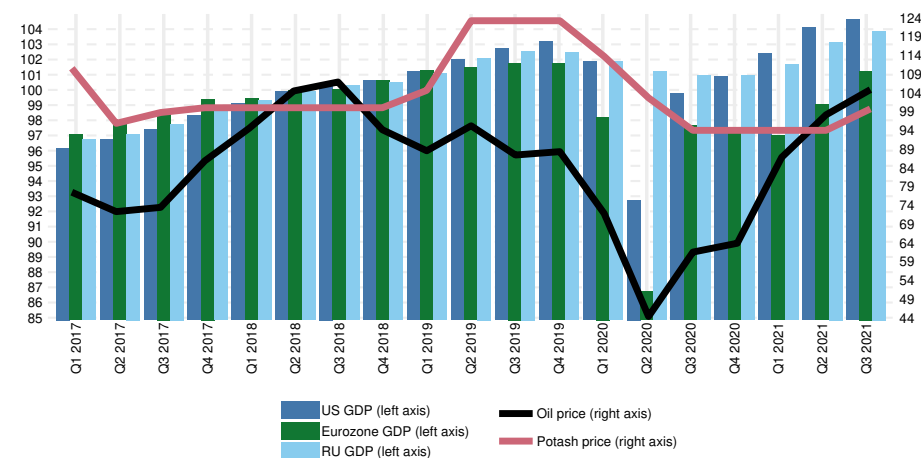
Output growth slowed down in most of the world's major economies in Q3. The main reasons for this were production and logistics shocks. New disruptions in production chains (the corresponding indices reached peaks comparable to the first pandemic wave in 2020) were associated with the outbreak of the delta strain of coronavirus as well as trade disputes. Sea freight prices reached historical peaks largely for the same reasons. Against this background, inflation remained high. Global concerns about growth prospects and price stability for 2022 began to intensify.

### External price competitiveness indices, 2015=100



Note: The price competitiveness index is calculated as the product of the terms of trade index and the reverse REER index, multiplied by 100.

### Global economic indicators, 2015=100



Note: All the GDP series are seasonally adjusted. The commodity price indices are calculated based on the World Bank data.

## External operations

### Is the foreign trade miracle drying up?

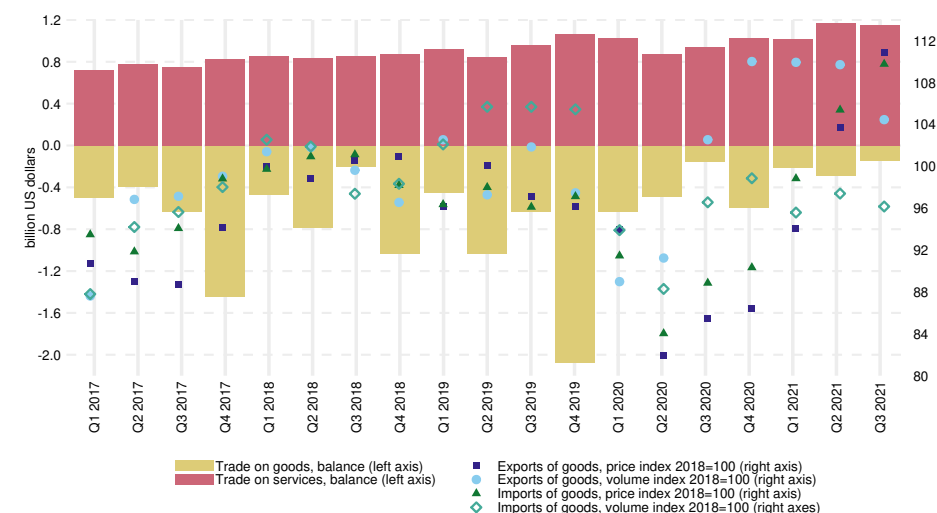
In Q3, the foreign trade miracle probably began to dry up. At least in the form of a surge in exports and a lagging growth in imports, which was the case over the last year. For the first time during this period, export volume decreased compared to the previous quarter (by 4.8%, with eliminated seasonality). Exports contracted in practically all aggregated commodity groups (investment, intermediate and consumer non-food goods). The only exception was food exports. By geographical destination, the decline was rather uniform.

Imports decreased as well, but at a much more modest rate (by 1.3%). This partly compensated the gap between the physical volume of exports and imports formed during the last year. Among commodity groups, imports of intermediate and consumer non-food goods decreased slightly, while imports of investment goods and food even increased slightly.

### New peaks in external borrowing costs

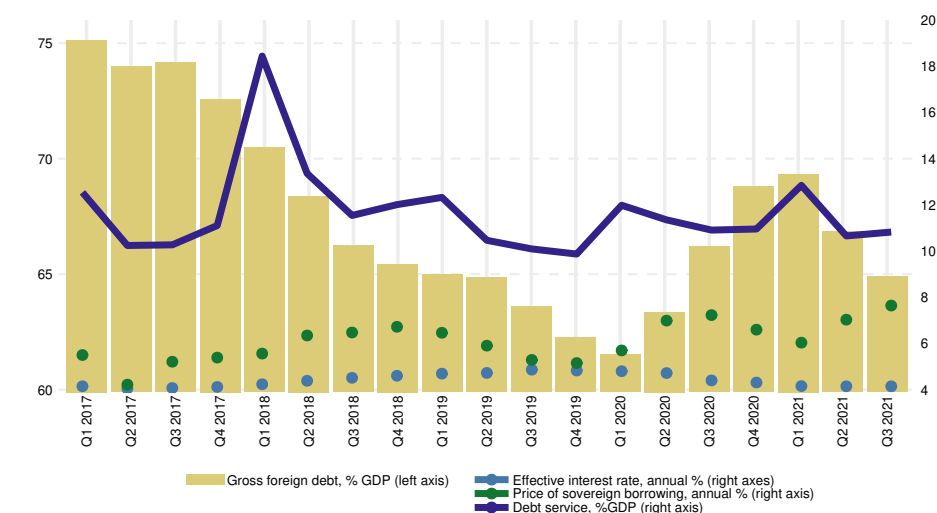
The migration crisis and new sanctions packages have further increased the yields on Belarusian Eurobonds. The yield to maturity has settled in the range of 7-8% (depending on maturity), which in the current environment means a high assessment of Belarusian sovereign risk by Eurobond holders.

### Prices and volume of international trade, 2015=100



Note: PI – price index; PVI – physical volume index. The indices are seasonally adjusted. The balance of trade is not.

### Volume and price of foreign borrowings



Note: Debt service data in % of GDP include both interest payments and principal repayments. The effective interest rate is calculated as a ratio of public debt interest payments over the last 4 quarters to the average public debt size over that period. The cost of sovereign borrowings is an estimate calculated as the average yield to maturity for all sovereign Eurobonds outstanding at the time of calculation.

## Social sphere

### Labour market compensates for rising wages with falling employment

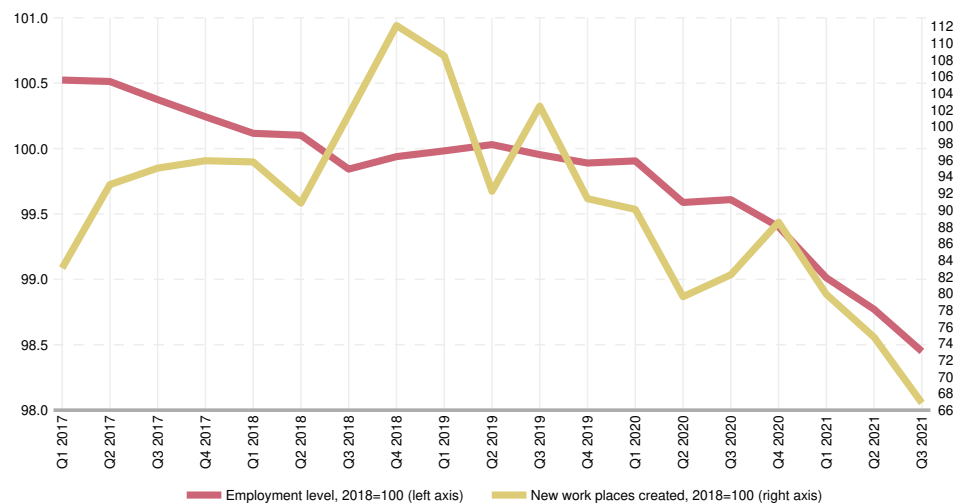
In Q3, growth in average real wages (compared with Q2) slowed to near zero. Against the backdrop of continued labour productivity growth (due to lower employment), this led to a return of real unit labour costs to their equilibrium level. In other words, the wage overhang created by a massive wage rise in the last 5 years, has gradually disappeared. The main mechanism of its elimination was a decreasing employment. The stability of this very trend has made it possible to avoid a significant drop in labour productivity even during a pandemic, for example. This, in turn, is largely a consequence of demographic change. However, in recent periods firms have also contributed to this trend.

With limited ability to vary wages flexibly (due to administrative pressure and competition for personnel), they are steadily reducing the number of new jobs created. In Q3, this figure reached a historic low.

### Real pensions have fallen significantly

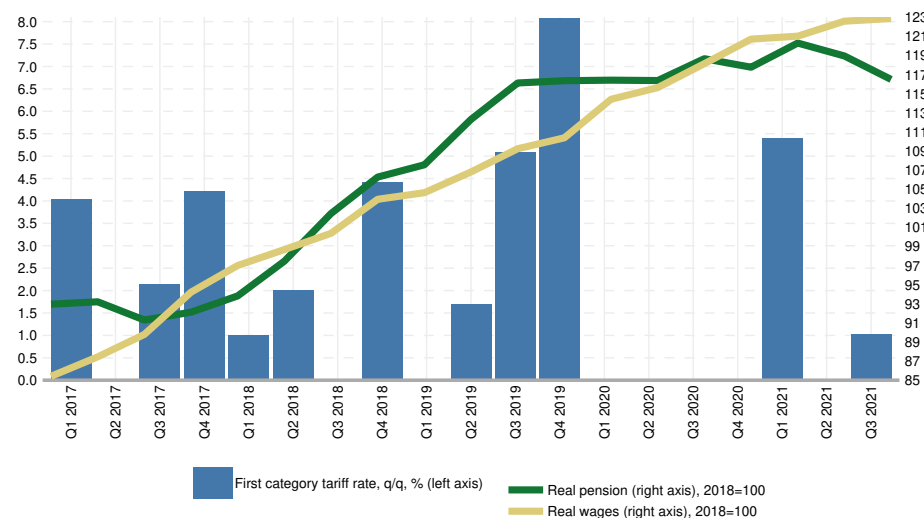
Real pensions (and other social transfers) fell significantly in Q3. High inflation had a greater impact on them than modest adjustments to the corresponding nominal rates. Against the backdrop of inflation, rising income disparities are likely to become a new persistent trend.

### Employment and new jobs, 2015=100



Note: The indices are seasonally adjusted.

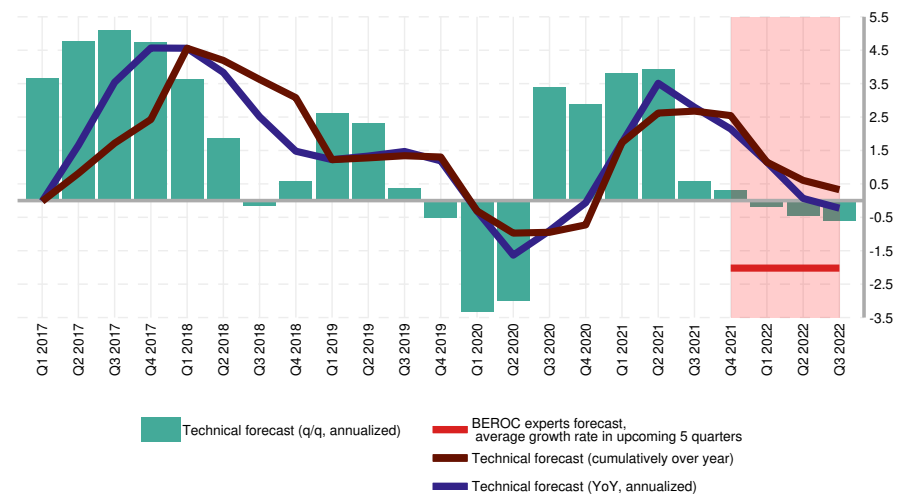
### First category tariff rate and household income



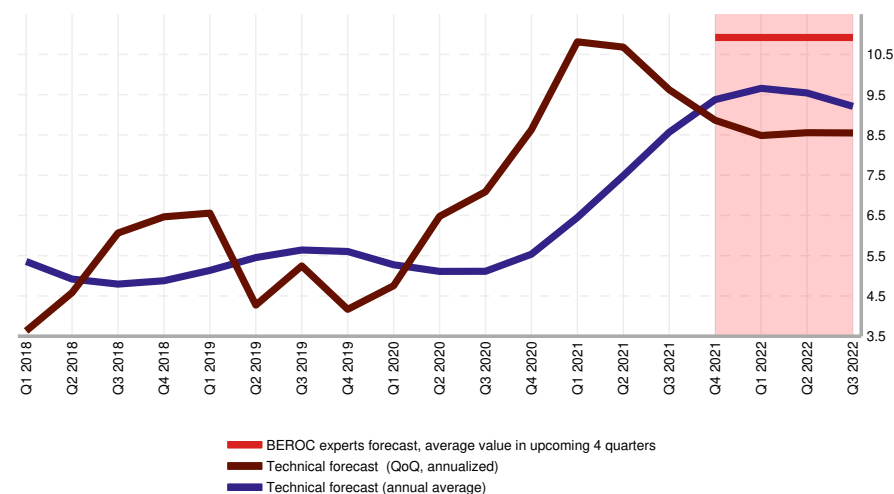
Note: The indices are seasonally adjusted.

## Technical forecast

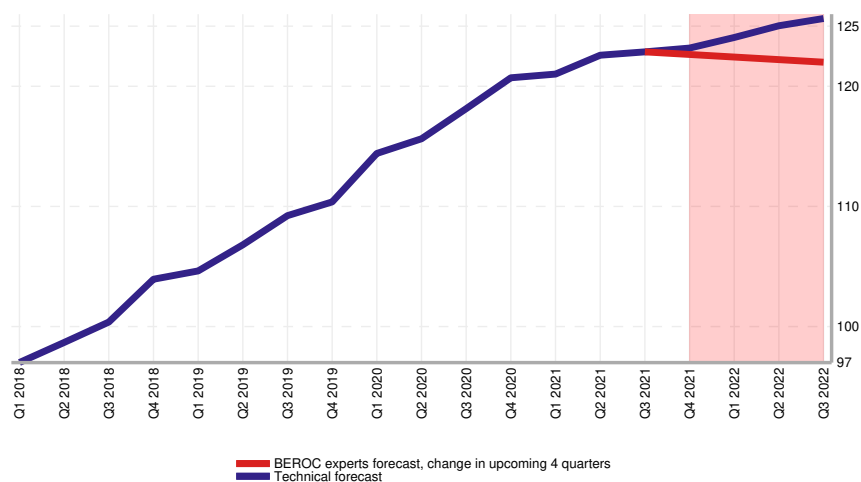
### Output growth, quarter on quarter, % (annualized)



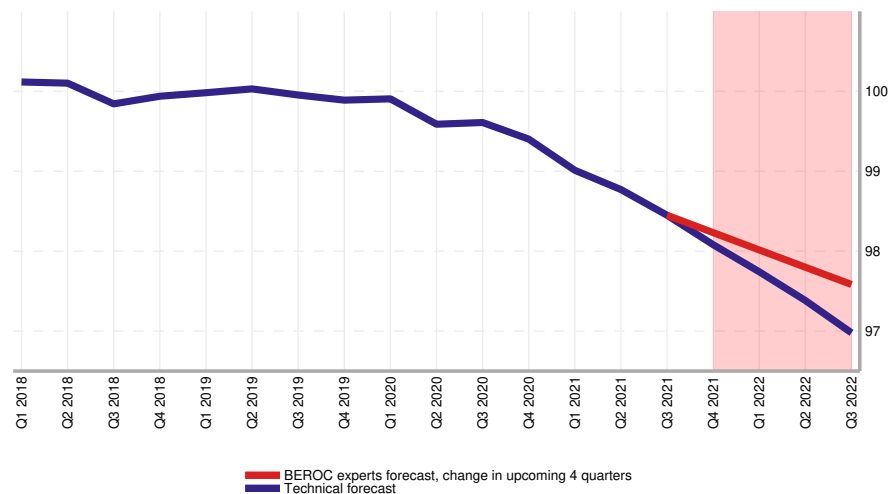
### Inflation rate, annual average, %



### Real wages, 2015 =100



### Employment, 2015 = 100



The technical forecast is an automated procedure that selects the best specification of ARIMA model for a certain dataset based on the Akaike information criterion and employs this model for forecasting for 5 upcoming quarters. An ARIMA-based forecast just takes into account past trends of the selected indicator and doesn't consider other economic variables, either in the past or in the future. The term "technical forecast" means that it doesn't include any linkages between economic indicators and is fully based on statistical methods. To correctly interpret this type of forecast one should use it as an answer to the following question: "What would happen to a particular indicator in the short-run, provided that the baseline scenario is applied, i.e. in case the fundamental parameters of the economic environment don't change, no exogenous shocks impact the economy, and fiscal and monetary policies remain unchanged compared to the current period?" BEROEC's judgmental forecast shows the medium-term equilibrium of a relevant indicator, to which the latter would gravitate in the coming 5 quarters.

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National Bank of the Republic of Belarus ([www.nbrb.by](http://www.nbrb.by))

International Monetary Fund ([www.imf.org](http://www.imf.org))

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